Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

17 May 1985

Foreign Investment in China: Patterns and Prospects

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Summary

Since 1979 more than 2,100 joint ventures, cooperative enterprises, and businesses wholly owned by foreign firms have been established in China. By the end of 1984 total paid-in foreign investment in these enterprises had grown to $3.7 billion, almost 60 percent higher than the yearend figure for 1983. Nevertheless, the total is far short of China's needs and we expect Beijing to seek substantially increased foreign investment over the course of the Seventh Five-Year Plan (1986-1990). Because China's top priorities include areas where US firms have a competitive edge--development of the transportation system, communications network, and energy supplies--we expect US firms to benefit substantially from China's drive for modernization.

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Recent Developments

Until last year Beijing's progress in attracting foreign investment had been slow, in large part, because of an uncertain commitment among Chinese leaders and planners on the extent of incentives that should be offered to foreign companies. Other obstacles to success included China's inexperience, its need to develop credibility in relationships with foreign businessmen, its lack of adequate infrastructure, problems with labor productivity and wages, and the lack of detailed regulations on taxes and remittances of profits.

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Beginning in 1983, however, Beijing made a range of concessions in a bid to gain more foreign participation in modernizing the economy. Scores of new laws have been released to attract or protect the foreign investor. In September of

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This memorandum was prepared by of the China Division, Office of East Asian Analysis and is based on information through 10 May 1985. Comments may be directed to Chief, Development Issues Branch

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that year, China issued regulations to clarify its 1979 Joint Venture law. The rules offered longer tax holidays, increased opportunities to sell the output of the venture in the domestic Chinese market, and more decisionmaking autonomy for the venture. Early last year China introduced new tax rules that exempt joint ventures from import duties and abolish certain industrial taxes on ventures that import advanced machinery and technology. In April 1984 the National People's Congress (NPC) formally ratified Deng's decision to open 14 additional port cities and Hainan Island to foreign investment, giving entrepreneurs many of the advantages available in the Special Economic Zones. Since then most of the new zones have developed extensive laws and regulations to attract foreign investment.

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By the end of last year Chinese authorities had granted approval for 930 "equity" and at least 1,100 "contractual" joint ventures.* In addition, there were 18 cooperative projects for prospecting and exploitation of offshore oil, and 74 wholly owned foreign enterprises. Total paid-in foreign investment on these four forms of direct investment reached approximately $3.0 billion by the end of 1984. If licensing agreements, processing arrangements, and compensation trade are included in the totals, in accord with Chinese practice (as shown in the tabulation below), total paid-in foreign investment amounted to $3.7 billion through the end of 1984.

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As of this past December, US investors had spent more than $700 million on joint projects in China. There were 56 equity joint ventures involving about $150 million, one $10-million cooperative management project, and eight agreements for joint exploitation of offshore oil into which $550 million have been sunk. The three largest nonoil Sino-US joint ventures are the Great Wall Hotel with US participation of $35 million, the Jianguo Hotel with US assets of

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* From a Western viewpoint, both forms of joint ventures, as well as joint oil exploration agreements and wholly owned foreign subsidiaries, would be considered direct foreign investment. In their definition of foreign investment, however, the Chinese also include other forms of business arrangements, such as licensing, processing, and compensation trade agreements, even though no foreign claims on real assets located in China exist. The Chinese sometimes use the term "foreign investment" loosely to refer to all forms of foreign participation, even including foreign loans to Chinese enterprises. From a Chinese legal viewpoint there are three chief distinctions between contractual and equity joint ventures. Equity joint ventures:

- -- Fall under the Joint Venture Tax law (a flat 33-percent tax), whereas contractual ventures are taxed on a graduated basis under the Foreign Enterprise Income Tax. 25X1
- -- Share profits in proportion to equity participation, whereas contractual joint ventures share profits according to a ratio agreed to in the contract.
- -- Form new legal entities with their own boards of directors, whereas contractual joint ventures are managed directly by their parent corporations.

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$11 million, and American Motors' Beijing Jeep Corporation with $16 million in US assets. [redacted] 25X1

Hong Kong investors accounted for about $2.2 billion of the $3.7 billion direct investment total. Hong Kong businessmen, however, are not motivated simply by the desire for profits but also by their desire to establish better relationships with the Communist Chinese in order to protect their assets in the post-1997 period. Therefore, to a certain extent, the figures for total direct foreign investment overstate the willingness of Western entrepreneurs to get involved in China. [redacted] 25X1

Direct Foreign Investment in China (a)
(Million US$; yearend)

Type	Pledged				Paid-in		
	1981	1982	1983	1984	1982	1983	1984
Total	2,846	4,958	6,600	9,474	1,769	2,345	3,726
Equity Joint Ventures	88	141	340	1,407	103	166	n.a.
Contractual Joint Ventures	1,800	2,726	2,900	4,384	530	730	n.a.
Joint Oil Exploration	498	999	2,000	n.a.	486	651	1,171
Compensation Trade	460	725	930	n.a.	413	542	n.a.
Other Businesses (b)	...	367	420	n.a.	237	254	n.a.

(a) Data are cumulative stock figures that have been compiled from articles in various Chinese economic journals. Data for "paid-in" direct foreign investment presumably include foreign cash, material, and technology contributions to joint enterprises; however, we do not know whether it also includes loans to such enterprises, i.e., any nonequity contributions. In the case of compensation trade, where "equity" exists only in the broadest sense of the word, it is not clear whether the figures include just the value of the machinery contributed by the foreign partner or the total value of goods traded under the agreements. China generally uses the accrual basis for accounting, and the above figures probably were derived on that basis.
(b) Includes wholly owned foreign enterprises and licensing agreements.

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Despite the obstacles to foreign investment posed by differences in economic environments and investment philosophies between China and the West, in the last year China has succeeded in its efforts to attract foreign investment. At yearend 1983--the last year for which we have comparable data--foreign investment in China was on a par with that in South Korea, just slightly below that in Taiwan, and about one-quarter the level in the other Asian NICs--Hong Kong and Singapore--and Indonesia (see tabulation below). By the end of 1984, however, foreign investment in China--led by exploration for offshore oil--had surpassed

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that in both Taiwan and South Korea by a wide margin. [redacted] 25X1

Direct Foreign Investment, Paid-In, for Selected East Asian Countries
(Billion US$, yearend 1983)

China (a)	1.5
South Korea	1.5
Taiwan (b)	1.5-2.0
Indonesia (c)	5.1
Hong Kong (d)	6.0-8.0
Singapore (d)	5.0-7.0

(a) Excluding compensation trade.
(b) Estimated from data on commitments.
(c) Excluding offshore oil.
(d) Estimated from official data on investment in the manufacturing sector and from other indicators.

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Prospects During the Seventh Five-Year Plan

China's competitive offshore leasing program got under way in 1983 with the signing of exploration and development contracts with 27 foreign oil companies, including 10 US firms. Drilling began in 1984 on most of the blocks that are located in the Yellow and South China Seas. Atlantic Richfield found a commercially viable natural gas field in its concession south of Hainan Island and is urging China to use the gas from this field to produce fertilizer on Hainan. The Japanese have had success exploring in the Bohai and have begun development of at least one field. Drilling results offshore have been generally disappointing, however, and the Chinese are now beginning to provide greater incentives to foreign participation, including opening onshore areas to foreign exploration and development. By yearend 1984, Japanese, French, and US firms had spent nearly $1.2 billion on offshore exploration and development. China expects to sink as much as $20 billion into oil exploration and development by 1990. [redacted] 25X1

Since last October China has signed joint venture agreements with Western firms that will ultimately generate about $7 billion in capital imports from the West (see tabulation below). The giant Daya Bay nuclear power plant deal alone accounted for nearly half of the total, and transportation related investments were responsible for another 40 percent. The surge in contract signings is related to China's economic planning cycle--most contracts for major projects that are scheduled for start-up during the Seventh Five-Year Plan (1986-1990) must be signed this year if the projects are to be completed by the end of the plan. [redacted] 25X1

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The Chinese have stated that they plan to obtain about $50 billion in capital goods from the West during the course of the plan, perhaps half of which will be obtained under joint venture and cooperative exploration agreements. They are currently negotiating several large contracts for nuclear power, coal field development, steel facilities, and chemical plants. The Chinese have signed preliminary agreements with foreign investors for development of the Pingshuo and Jungar open pit coal mines. In mid-1984 they were in the process of arranging financing for these projects and work could begin this year.

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In light of China's past aversion to foreign involvement in the economy it is perhaps surprising that the Chinese appear to view foreign investment more favorably than foreign debt as a means of financing economic development. Nevertheless, the Chinese see many advantages in attracting direct foreign participation. Foremost among them is the hard currency saved as a result of foreign equity contributions. But the Chinese are also anxious to obtain access to Western markets, technology, and managerial talent and believe that direct foreign investment is the best way to gain that access. Moreover, the Chinese are hopeful that foreign investment will provide new employment opportunities for the large number of people who enter the workforce annually.

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Remaining Obstacles to Foreign Investment

The greatest hindrance to foreign participation in China's economic development remains China's unwillingness to adopt Western practices with regard to the transfer of ownership of assets. The Chinese continue to insist on time limits to joint ventures, after which capital is turned over to their side. As a result, Western partners are unwilling to provide state-of-the-art technology as the expiration date nears. The Chinese, furthermore, have not agreed to Western guidelines on what consitutes expropriation, nor have they agreed to "prompt, adequate, and effective" compensation in the event of expropriation. They also maintain the right to approve of the disposal of assets in the event a foreign partner becomes bankrupt, severely hampering foreign loans to joint-venture enterprises. Finally, lacking a convertible currency, the Chinese invariably insist that joint ventures earn sufficient foreign exchange to cover their profit remittances. [redacted] 25X1

Most of these issues would be addressed by the bilateral investment treaty (BIT) proposed by the United States. Unless major changes are made in China's economic system, however, the Chinese probably will not agree to several of the provisions. Irrational domestic prices are the greatest barrier to concluding a BIT. Because China's domestic prices are not in line with world prices, China cannot grant "national treatment" to foreign firms since this would allow them to make windfall profits at China's expense.

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SUBJECT: Foreign Investment in China: Patterns and Prospects [redacted]

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